United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

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74-1272

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

JEFF SIMON, as Custodian for GAIL NINA SIMON,
Under the New York Uniform Gifts to Minors Act,
Plaintiff-Appellant,

vs.

THE NEW HAVEN BOARD & CARTON COMPANY,
INCORPORATED, *et al.,*
Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF CONNECTICUT

BRIEF OF DEFENDANT-APPELLEE WILLIAM B. GUMBART

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Statement of the Case

This action under Rule 10b-5, with a claim under state law joined upon diversity jurisdiction, arises out of a merger in 1964. The action was brought against several defendants, including defendant-appellee William B. Gumbart, then a director of The New Haven Board & Carton Company, Incorporated ("New Haven"); he had served as a director for about seven years before the trans-

action. New Haven was publicly held with shares traded in the over-the-counter market.

In July of 1963, a group referred to here as "the Simkins Interests" acquired effective control of New Haven by purchasing several blocks making up about one-third of New Haven's outstanding shares.

The Simkins Interests owned several closely-held Florida companies ("the Miami Companies") engaged in manufacturing businesses similar to New Haven's. The Simkins Interests proposed the merger of New Haven and the Miami Companies, and the merger agreement was approved by New Haven's directors January 16, 1964, subject to shareholder approval. Proxies were solicited from New Haven shareholders by proxy statement dated February 12, 1964, mailed February 14, 1964, together with New Haven's annual report for the fiscal year ending September 30, 1963. (Trial Court's Memorandum of Decision, p. 2; Appendix S-2; App. E; App. F.) Shareholders approved the merger February 28, 1964, and it was consummated directly after that by New Haven's issuance of 1,377,774 common shares to the Simkins Interests for all of the outstanding shares of the Miami Companies.

Plaintiff brought this as a derivative action on behalf of New Haven. As discussed below, at trial, plaintiff narrowed the claims earlier alleged in his pleadings to claims of material misrepresentations and omissions in the proxy statement and annual report mailed February 14, 1964, and claims of injury to New Haven arising from such misrepresentations and omissions. New Haven was not subject to the proxy rules under the Securities Exchange Act of 1934 or the Securities Acts Amendments of 1964. (See Mem. of Dec., n. 3; App. S-24.)

It is pertinent to this appeal to describe briefly: (a) the pleadings and limited claims on which this action was tried below; and (b) the course of the trial.

The complaint was filed April 24, 1964. Defendants moved to dismiss for lack of jurisdiction and improper venue June 26, 1964. After hearing May 17, 1965, an order was entered May 21, 1965, granting portions of defendants' motion and permitting the filing of a substituted complaint. Plaintiff filed his Amended Verified Complaint on June 16, 1965, and, after further motions, a Second Amended Verified Complaint on October 21, 1965. (App. A, pp. 2-4.) It was upon his Second Amended Verified Complaint that this action was tried, and that will be referred to here as "the Complaint".

Plaintiff alleged in paragraphs 9 through 16 of Count I of the Complaint that during 1963 and 1964 the Simkins Interests and other defendants engaged in a plan, scheme, and conspiracy, involving continuing and concerted activity to distort reports to shareholders, to conceal and disguise New Haven's activities and the objectives of the Simkins Interests, and to deceive shareholders into approving the merger in 1964 "despite its unfairness", in order to waste New Haven's assets, to obtain secret profits, and to carry out a scheme engineered by conspirators to mulct New Haven of 1,377,774 shares for inadequate consideration. Jurisdiction was rested upon diversity of citizenship, and because of venue problems, Count I was aimed only at defendants Miller, Chatfield, and Gumbart.

Count II of the Complaint, directed at all defendants, realleged the plan, scheme, and conspiracy, set out in Count I and, resting jurisdiction and venue upon Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. §78aa, alleged violations of Section 10(b) of that Act and Rule 10b-5 under it, in connection with the proxy statement and report sent to solicit approval of the merger in which New Haven issued shares of stock to acquire the Miami Companies.

At the commencement of trial, plaintiff narrowed his broad claims:

> "MR. SCHARF: . . . I would advise the Court, however, that in connection with the claims of misrepresentation, fraud, non-disclosure, *et cetera,* such as alleged in the complaint, we shall be relying upon two items which it has been stipulated may be introduced into evidence, to wit, an annual report for the year 1963, and a proxy statement and notice of annual meeting and special meeting of stockholders which is dated February 12, 1964. It has been stipulated that both of these documents, together with the proxy form, were mailed out as indicated by an affidavit of mailing which shall also be introduced in evidence. But the focus of the case, if your Honor please, are the representations made in these two documents . . . [Tr. 2-3]"

The Complaint seeks various relief, including an injunction against the merger, rescission of the merger, appointment of a receiver, an accounting for profits, an adjudication of violations of Rule 10b-5, and an adjudication of defendants' liability to New Haven "for all loss, injury and damage caused to it by virtue of the acts and transactions complained of in this Count, including the sale by New Haven of said 1,337,774 [*sic*] shares of its common stock. . . ." (App. B, 23-24, 28.) As appears from the opinion of the Trial Court, the issuance of shares for the Miami Companies was based on a ratio equivalent to a price of $4.50 per share for the New Haven shares issued. (Mem. of Dec. p. 7, App. S-7.)

During the trial, however, plaintiff stated:

> "MR. SCHARF: Good morning, your Honor. I just have a brief opening remark, if your Honor please. I am not sure if the record contains the withdrawal by the plaintiff, which was stated at the pretrial conference, of a claim for recision [*sic*] of the merger.

> The plaintiff relies solely upon a claim for damages and an accounting for profits by the defendants.
>
> THE COURT: All right.
>
> MR. SCHARF: I just wanted to make that clear. [Tr. 832.]

At the end of the trial, Mr. Scharf characterized plaintiff's claims twice more:

> Our basic objection [to the merger] is we didn't get a big enough piece of the pie, because he was making delicious pie. [Tr. 1272.]
>
> * * * * *
>
> . . . [I]t is a case relating to fairness of ratio. . . . [Tr. 1289.]

Thus, plaintiff plainly made the crux of his claim to be that New Haven was harmed by an unfair or inadequate merger ratio in acquiring the Miami Companies and that, if so, defendants should be required to account for and disgorge profits wrongfully obtained and damages for injury to New Haven.

Indeed, almost all of the evidence at trial consisted of: (a) the testimony of Dr. Douglas H. Bellemore, a financial expert for plaintiff, to the effect that the value of the New Haven shares at the time of the merger should have been not $4.50 per share but somewhat over $8.50 per share, putting particular weight on the unaudited internal financial report for New Haven's first quarter of fiscal 1964; (b) testimony of Professor Pierson Hunt of the Harvard Graduate School of Business Administration, an investment expert for defendants, that an analysis of the transaction showed that the fair market value of the New Haven shares at the time of the transaction was not in excess of $4.50 per share; and (c) extensive testimony by New Haven's management and accountants that necessary and substantial corrections and adjustments to the uaudited

internal financial report made it improper for Dr. Bellemore, or anyone else, to rely on it.

The Trial Court's characterization of the claims and pertinent findings are:

> . . . A principal but not the only challenged item is the omission of the results of an unaudited internal financial report for the company's first quarter, ending December 31, 1963, of its 1964 fiscal year. This report, prior to correction, showed first-quarter profits of $148,590. Plaintiff's essential contention, in support of which its expert, Dr. Douglas Bellemore, testified at length, is that disclosure of this first-quarter report would have provided a basis on which shareholders could have concluded that the value of New Haven shares at the time of the merger was not $4.50 per share, but $8.62½ per share. Using this higher price per share, plaintiff claims that New Haven was damaged in two ways: (a) by "paying" too much for the Miami shares; the overpayment is claimed to be the alleged price per share of $8.62½ times the number of shares issued, 1,377,774, or $11,883,301, less the value of thee shares received in exchange $6,200,000, a difference of $5,683,301, and (b) by losing the opportunity to sell, at the highest price since the merger the "extra shares issued to the Simkins; since a price per share of $8.62½ divided into the $6,200,000 value of the Miami companies would have required issuance of only 718,841 shares, plaintiff subtracts this figure from the 1,377,774 shares actually issued to arrive at 658,933 "extra" New Haven shares issued to the Simkins, which, at post-merger high price of $21.50 per share, might have been sold to the public at a total price of $8,483,762. Plaintiff seeks a money judgment of $14,167,063 in damages plus an accounting of the profits made by the individual defendants.
>
> At trial plaintiff made clear that it was abandoning earlier claims for recission and was limiting its requested relief solely to a claim for damages and an

accounting. From the above computations, it is apparent that the lynch pin of the claim for damages is the alleged price of New Haven shares of $8.62½, or any price above the merger price of $4.50. Moreover, analysis of plaintiff's causes of action will demonstrate that plaintiff is entitled to no judgment unless the company has been damaged by issuance of its shares at the $4.50 price.

* * * * *

From the evidence in this case, it is apparent that the issuance of 1,377,774 shares valued at $4.50 per share caused no damage whatever to the corporate integrity of New Haven. There was no evidence to show any diminution in the Company's capacity, as a result of the merger ratio, to attract capital or loans. On the contrary, the merger vastly improved the company's financial structure and operating capability. Thus, the only theory of damages available to the plaintiff, on the 10b-5 count, is that the merger resulted in receipt of inadequate consideration or, to put it another way, issuance of an excessive number of shares. Since plaintiff disclaimed any attack upon the valuation, by independent appraisal, of the value of the Miami companies received in exchange for the New Haven's shares, and there was no evidence that the Miami companies were overvalued, the claim of inadequate consideration rests entirely on the contention that the issued New Haven shares were worth in excess of $4.50 per share. [Mem of Dec. pp. 4-7, App. S 4-7.]

After a careful review of the testimony of Dr. Bellemore, for plaintiff, the testimony of Professor Hunt, for defendants, and the evidence relating to New Haven's accounting, reports, and financial condition, the Trial Court concluded:

> Despite the subjective element in the analysis, Professor Hunt's testimony remains far more persuasive than Dr. Bellemore's. Because of the inappropriateness of a price-earnings ratio analysis and the glar-

> ing defects in the particular analysis made by Dr. Bellemore, his conclusion lacks persuasive weight. On the other hand, Professor Hunt's analysis provides a substantial basis for concluding that $4.50 per share was not less than the price reasonable to be paid as the fair value for the investment opportunity represented by the New Haven shares issued in the merger. To the extent his conclusion involved a subjective evaluation, that evaluation was based on a careful consideration of the company's prospects, giving due weight to its past financial difficulties and its prospects for improved performance under capable management.
>
> * * * * *
>
> Neither side attempted to establish fair market value by any other measure than those already discussed. While plaintiff complains that defendants offered no evidence of what the fair market value was, their evidence was presented not to prove a precise fair market value but to show that the fair market value was not in excess of $4.50. As can be seen, all of the evidence, while lengthy, is not entirely satisfactory. Nevertheless, assessing all of the evidence, this Court comes to the firm conclusion that even if defendants bear the burden of proof on the state claims, the New Haven shares issued at the time of the merger did not have a fair market value in excess of the merger price of $4.50 per share. [Mem. of Dec. pp. 21-23, App. S 21-23.]

After a trial upon the issues as framed by plaintiff, the issues have been found for defendants. The findings are not clearly erroneous, and the judgment should be affirmed.

I.

The Judgment Below On The Rule 10b-5 Claim As To Defendant Gumbart Should Be Affirmed Because Plaintiff Presented No Evidence of Scienter, And The Court Found No Scienter Sufficient to Support Liability.

As stated above, at the outset of the trial plaintiff abondoned attempts to show a months-long scheme and limited himself to claims of material misrepresentations and omissions in New Haven's annual report to shareholders for fiscal 1963, sent together with its proxy statement, February 14, 1964. (Tr. 2-3.) New Haven was not subject to the proxy rules under the Securities Exchange Act of 1934, 48 Stat. 895, 15 U.S.C. §78n(a), and the regulations thereunder, 17 C.F.R. §§240.14a-1 to 240.14a-103; the Securities Acts Amendments of 1964, 78 Stat. 565, did not affect New Haven until January 28, 1965, and no earlier registration brought New Haven within the scope of the proxy rules. (Mem. of Dec., n.3, at p. 74; App. S-24.)

In its *en banc* opinion in *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1304-1305 (2d Cir. 1973), this Court stated:

> . . . [O]ur recent decision in *Shemtob* v. *Shearson, Hammill & Co.*, [488 F.2d 442, 445 (2d Cir. 1971] eliminated any doubt that proof of scienter is required in private actions in this circuit. There, in the context of a private action for damages, we stated that no violation of Rule 10b-5 occurs 'in the absence of allegation of facts amounting to *scienter*, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme, or artifice to defraud. It is insufficient to allege mere negligence.' 448 F.2d at 445. Under the *Shemtob* test, a plaintiff claiming a violation of Rule 10b-5 who cannot prove that the defendant had actual knowledge of any misrepre-

> sentations and omissions must establish in order to succeed in his action, that the defendant's failure to discover the misrepresentations and omissions amounted to a willful, deliberated, or reckless disregard for the truth that is the equivalent of knowledge.

This Court expressly rejected the position that the corporate director is, by virtue of that position alone, an insurer of statements made for the corporation which are subject to Rule 10b-5. *Id.* at 1306-1309.

In *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1298-99 (2d Cir. 1973), this Court grounded the distinction between the scope of liability for violations of the proxy rules and the more limited scope of liability for violations of Rule 10b-5 under Section 10(b) of the Securities Exchange Act of 1934 upon the presence of the "evil-sounding language" addressed to 'any manipulative or deceptive device or contrivance' in Section 10(b) but not in Section 14(a). See, *e.g. Smallwood* v. *Pearl Brewing Co.*, 489 F.2d 579, 606(5th Cir. 1974); *Republic Technology Fund, Inc.* v. *Lionel Corp.*, 483 F.2d 540, 551 (2d Cir. 1973); *Cohen* v. *Franchard Corp.*, 478 F.2d 115, 123 (2d Cir. 1973); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 854, 868 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied sub nom. Coates* v. *SEC*, 394 U.S. 976, 89 S.Ct. 1454, 22 L.Ed.2d 756.

Plaintiff's main claim of misrepresentation is the omission of the results of New Haven's unaudited internal report for the first three months of fiscal 1964. Plaintiff claimed that the report, before corrections and adjustments, showed first-quarter profits of $148,590. (Mem. of Dec. 4, App. S-4.) The evidence is that this report was not shown to directors such as defendant Gumbart before the proxy material was mailed. (Tr. 791.) It was not discussed at the directors' meeting authorizing solicitation of proxies to

approve the merger in January of 1964; it was not yet available then. (Tr. 923.)

The Trial Court found:

> "Defendants also offered the testimony of Leon Simkins, president of the company, and Attorney William Gumbart, a director. Both witnesses, in view of their roles with the company and their status as defendants in the case, have an obvious interest in the outcome. Even when their testimony is assessed with this consideration in mind, their testimony is extremely credible and persuasive. Simkins impresses as an honest and capable businessman. He considered the $4.50 bid price on the over-the-counter market to be somewhat high and artificial in the absence of trading, but was reluctantly willing to accept it. Gumbart impresses as a wise and experienced observer of the company and of the state of the market for the company's shares. He testified that the alleged market at $4.50 per share was high, that few shares could be sold, and that no investors were putting money into the company's stock at any price." [Mem. of Dec., p. 22; App. S-22.]

Defendant Gumbart testified that he had had some acquaintance with New Haven's affairs as far back as fifty years ago, that he became a director in 1957, that at that time and in the following years up to 1964, New Haven was in serious difficulties and, although it had an occasional good quarter, a precarious financial position. (Tr. 1224-29.) Things got to the point of discussing receivership for New Haven. (Tr. 1231-32.) When the Simkins Interests acquired control, he was impressed with their diligence, their industry, and their scrutiny of New Haven's operations. (Tr. 1232-33.) He made inquiries about the Simkins' credit, integrity, and business ability; he made similar inquiries about the accountants used by the Simkins Interests; and he looked into the profits and general business

outlook for the Miami Companies. The results were excellent. (Tr. 1234-35.) He viewed the proposed merger as fair (Tr. 1235) and was very much in favor of it.

> I thought we were making a marriage with profitable companies and with efficient and successful management which would pull the creditors and stockholders of New Haven Board & Carton out of a sinking ship.
>
> Now of course this ship might not have sunk, but it certainly was leaking. And my experience was such that I thought it was the only salvation for Board & Carton to make sure that we got these profitable companies merged into it and make sure that we had capable effiicient management. [Tr. 1234.]

The $4.50 price for New Haven shares was "plenty high" in his opinion. [Tr. 1245.] As to the proxy material:

> Q. [Mr. Scharf] Did the Simkins ask you to review that proxy statement in order to elicit your opinion as to its fairness in presentation and its adequacy, or did they leave that to their own lawyers? A. I am not sure, but I think they left it to their own lawyers. [Tr. 1237.]

On the law cited above, upon the findings of the Trial Court, and on the record as cited above, this Court should affirm the judgment as to defendant Gumbart because there is not the requisite showing of scienter on his part to establish liability.

II.

Mills v. Electric Auto-Lite Co., 396 U.S. 375(1970), Does Not Require the Trial Court to Determine Whether There Were Violations of the Federal Securities Laws in This Case.

Plaintiff relies heavily on the Supreme Court's opinion in *Mills* v. *Electric Auto-Lite Co.,* 396 U.S. 375, 24 L.Ed.

2d 593, 90 S.Ct. 616(1970), in his attempt to lead this Court to find that the proxy materials in question were materially false or misleading or to remand the case for further findings.

At pages 2 through 5 of his brief, plaintiff lists certain items he claims to have been misrepresented. These claims are without merit. For example, plaintiff states ". . . that the Simkins and their co-defendants failed to disclose [F-15] that the Simkins were in actual control of the NH board which recommended the merger. . . ." On the contrary, the proxy statement cited by plaintiff states, at page 15 of Appendix F, "As a result of direct and indirect ownership of New Haven's Common Stock, Leon J. Simkins and Morton H. Simkins may be deemed to have effective control of the Board of Directors and management of New Haven." The proxy statement showed that the Simkins Interests held about one-third of New Haven's outstanding shares, that Leon J. Simkins was president of New Haven, and that Morton H. Simkins was Executive Vice President and Treasurer. There is no basis for plaintiff's claim that the proxy statement was misleading about the Simkins' control of New Haven. This is characteristic of plaintiff's claims of misrepresentation.

Neither should the *Mills* opinion be read as plaintiff suggests. That case reached the Supreme Court not after a full trial, but in the midst of a set of interlocutory determinations. Plaintiff there claimed that a proxy statement favoring a merger was misleading in violation of Section 14 of the Securities Exchange Act of 1934, and the rules under it. On motion for summary judgment, the District Court found the proxy statement materially deficient and concluded that a causal relationship between the deficiency and the approval of the merger had been shown; it referred the case to a master for consideration of appropriate relief. The Court of Appeals for the Seventh Circuit reversed on

the question of causation. As the Supreme Court viewed the proceedings below, the Court of Appeals:

> . . . ruled that the issue [of reliance] was to be determined by proof of the fairness of the terms of the merger. If respondents could show that the merger had merit and was fair to the minority shareholders, the trial court would be justified in concluding that a sufficient number of shareholders would have approved the merger had there been no deficiency in the proxy statement. In that case respondents would be entitled to a judgment in their favor. [396 U.S. at 379-380, 24 L.Ed. 2d at 599-600.]

Thus, the Supreme Court rejected a rigid rule that would have allowed, in effect, the demonstration of the merit and fairness to minority shareholders of a merger to serve as a defense to claims under the proxy provisions of the Securities Exchange Acts of 1934 that a merger had been accomplished with misleading proxy material. Such rejection of a rigid rule should not be taken as the establishment of an equally rigid opposing rule.

The *Mills* opinion followed a finding of materially deficient proxy material and an interlocutory order for relief. However, even if such violation is found, federal courts are not held to follow a rigid formula in determining appropriate relief. The flexible approach typical of courts of equity is to be applied:

> ". . . One important factor may be the fairness of the terms of the merger. . . . In selecting a remedy the lower courts should exercise " 'the sound discretion which guides the determinations of courts of equity,' " keeping in mind the role of equity as "the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims." [396 U.S. at 386, 24 L.Ed. 2d at 603.] (Citations omitted.)

Here, there has been a full trial; plaintiff has cast his claims in terms of the alleged unfairness of the merger ratio; after careful review, the Trial Court came to "... the firm conclusion that even if defendants bear the burden of proof on the state claims, the New Haven shares issued at the time of the merger did not have a fair market value in excess of the merger price of $4.50 per share" and that the merger not only did not damage New Haven's corporate integrity but, on the contrary, vastly improved its financial structure and operating capability. In *Mills,* the Supreme Court indicated that in devising relief where there is a proxy violation, "one important factor may be the fairness of the terms of the merger." Here, it is apparent that the Trial Court, exercising its equitable discretion upon the full record, found the fairness of the terms of the merger, its effect upon minority shareholders, and its effect upon New Haven, in a carefully reasoned opinion, a factor of sufficient importance that further inquiry was not necessary. That exercise of discretion is fully justified upon the Trial Court's opinion and should not be disturbed by this Court.

III.

The Judgment Below on Plaintiff's State Claim Should Be Affirmed on the Trial Court's Findings.

Count I of the Complaint, based on diversity jurisdiction, alleged that the three director-defendants Gumbart, Miller, and Chatfield, who are residents of Connecticut, breached their fiduciary duties under Connecticut law. The allegations of Count I painted those directors as having taken part in a scheme during 1963 and 1964 to drain off New Haven's assets to the Simkins Interests. As quoted above, however, at the outset of the trial, plaintiff abandoned any attempts to show a continuing plan or conspiracy; the Trial

Court's findings quoted above show not only that there was no breach of fiduciary duties, they show that the outside directors who are the only defendants to whom Count I is addressed plainly acted in New Haven's interests.

> . . . There was no evidence to show any diminution in the company's capacity, as a result of the merger ratio, to attract capital or loans. On the contrary, the merger vastly improved the company's financial structure and operating capability. [Mem. of Dec. 7, App. S-7.]

Plaintiff did not allege that the terms of Section 33-323 of the Connecticut General Statutes applied to the three outside director-defendants in this transaction, and it is not clear that they do in that none of those directors had a personal interest in the merger. Even if those provisions did apply, however, they would only have the effect of placing on defendants the burden of showing that the transaction was fair and brought adequate consideration to New Haven. *Osborne* v. *Locke Steel Chain Co.*, 153 Conn. 527, 534, 218 A.2d 526, 530-31 (1966).

The Trial Court found:

> . . . Nevertheless, assessing all of the evidence, this Court comes to the firm conclusion that even if defendants bear the burden of proof on the state claims, the New Haven shares issued at the time of the merger did not have a fair market value in excess of the merger price of $4.50 per share. [Mem. of Dec. 22-23, App. S 22-23.]

These conclusions were not clearly erroneous, and the judgment on plaintiff's state claim should be affirmed.

CERTIFICATE OF SERVICE

I hereby certify that on July 2, 1974, two copies of this Brief of Defendant-Appellee William B. Gumbart were deposited in the United States Mails, first-class postage prepaid, addressed to Messrs. Bobroff, Olonoff & Scharf, 122 East 42nd Street, New York, New York 10017, and Messrs. Wiggin & Dana, 205 Church Street, New Haven, Connecticut 06509.

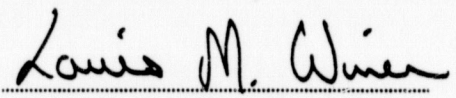
Louis M. Wiener

Attorney

CONCLUSION

For the foregoing reasons, the judgment should be affirmed.

Respectfully submitted,



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Dated: July 2, 1974.